No. 77-648

In the Supreme Court of the United States

OCTOBER TERM, 1978

FEDERAL ENERGY REGULATORY COMMISSION,
PETITIONER

v.

PENNZOIL PRODUCING COMPANY, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE FEDERAL ENERGY REGULATORY COMMISSION

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-9a)[1] is reported at 553 F.2d 485. The order on rehearing of the court of appeals (Pet. App. 12a-13a) is reported at 558 F.2d 816. The initial opinion and order (Opinion No. 753) of the Federal Power Com-

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[1] "Pet. App." references are to the appendix to the petition for certiorari filed by the Federal Energy Regulatory Commission. "A." refers to the Appendix in this Court.

mission (A. 254-263, Pet. App. 14a-26a) and its opinions and orders (Nos. 753-A, 753-B) denying rehearing (A. 290-295, Pet. App. 27a-33a; A. 296-299) are not officially reported.

JURISDICTION

The judgment of the court of appeals was entered on June 6, 1977 (Pet. App. 10a-11a). The Commission's application for rehearing was denied on September 1, 1977 (Pet. App. 12a-13a). The mandate of the court of appeals issued on September 9, 1977. On August 26, 1977, Mr. Justice Powell extended the Commission's time for filing a petition for a writ of certiorari to and including November 3, 1977. The petition was filed on that date and was granted on June 12, 1978 (A. 303). The Court's jurisdiction rests on 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, as amended, 15 U.S.C. 717r(b).

QUESTIONS PRESENTED

1. Whether the Natural Gas Act permits the Commission to establish rates for the interstate sale of natural gas that pass through to interstate consumers royalty costs based on the unregulated price of natural gas in the intrastate market.

2. Whether the Commission properly denied a request to permit lessee/producers of natural gas to abandon volumes of gas dedicated to interstate service so that those volumes could be paid as royalties "in kind" to landowner/lessors and sold on the intrastate market.

STATUTES INVOLVED

Sections 4(a) and 7(b) of the Natural Gas Act, 52 Stat. 822, 824, as amended, 15 U.S.C. 717c(a), 717f(b), are set forth as an Appendix, *infra*, p. 1a.

STATEMENT

Respondents Pennzoil Producing Company (Pennzoil) and Shell Oil Company (Shell) sell gas produced from the Gibson Field in Terrebonne Parish, Louisiana, to respondent United Gas Pipe Line Company (United) for resale in interstate commerce, as authorized by certificates of public convenience and necessity issued by the Commission. The gas is produced under leases obtained by Pennzoil and Shell from Williams, Inc. (Williams) dated August 29, 1934, and July 24, 1952. The leases provide for payment to the lessor of royalties equal to fixed fractions—one-eighth under the 1934 lease, one-fourth under the 1952 lease—of the value of the gas produced. That value is to be "calculated at the market rate prevailing at the well," or "calculated at the market price prevailing at the well" (A. 133, 145).

Pennzoil and Shell have always computed and paid their royalties under the leases as fractions of the rates actually received by them for the sale of the gas in interstate commerce, which rates since 1954 have been established by the Commission.[2] In 1973, 1974, and 1975, however, Williams demanded payment by

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[2] See *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672.

Pennzoil and Shell of royalties based on intrastate market values of natural gas. Those values assertedly ranged from 35 cents to 70 cents per Mcf (1,000 cubic feet) for the period October 1, 1971, through May 31, 1974, and from $1.30 to $1.40 per Mcf from June 1, 1974, through April 30, 1975 (A. 72-74, 119-121, 160-161). Those intrastate market values substantially exceeded the ceiling rates established by the Commission for the sale of the gas by Pennzoil and Shell.[3] When Pennzoil and Shell refused to pay the higher royalties, Williams purported to terminate the leases for underpayment of the royalties due (A. 160, 255).

In 1974, Pennzoil and Shell filed a petition in a state court in Louisiana seeking a judgment declaring that they were properly discharging their royalty obligations under the leases (A. 75-79). Williams counterclaimed for royalty underpayments in excess of $3.5 million (A. 120). The principal question before the state court was whether the terms "market rate" and "market price" in the royalty provisions of the leases referred to the unregulated intrastate market (as Williams contended) or to the regulated Commission rate at which the gas was actually sold (as Pennzoil and Shell contended) (see A. 91-94).[4]

[3] In 1975, for example, both Pennzoil and Shell received 31.11 cents per Mcf for some of the Gibson field gas sold to United, and 59.88 cents for the remainder (A. 42, 66-67). These rates, which included some adjustments, were established by the Commission's Opinion No. 598, *Area Rate Proceeding (Southern Louisiana Area)*, 46 F.P.C. 86, affirmed *sub nom. Mobil Oil Corp.* v. *Federal Power Commission*, 417 U.S. 283; and Opinion No. 699-H, *Just and Reasonable National Rates for Sales of Natural Gas*, 52 F.P.C. 1064, affirmed *sub nom. Shell Oil Co.* v. *Federal Power Commission*, 520 F.2d 1061 (C.A. 5), certiorari denied, 426 U.S. 941.

On June 18, 1975, before the state court ruled on that question, Pennzoil, Shell, and Williams entered into a settlement agreement (A. 15-25). The agreement provided that Pennzoil and Shell would apply to the Commission for authority to pay royalties based, in essence, on the higher of 78 cents per Mcf (increasing 1.5 cents per year after 1975) or 150 percent of the highest area or national rate per-

[4] Royalty provisions based on "market value," "market price," or similar terms appear to be fairly common in natural gas leases, although the Commission has no precise information concerning the number of leases containing such provisions or the volumes of gas covered. The issue whether such provisions refer to the unregulated intrastate market price or to the regulated rate at which the gas is actually sold is currently pending in numerous cases, but has been decided or considered in only a few reported decisions. One of these is *Lightcap* v. *Mobil Oil Corp.*, 221 Kan. 448, 562 P.2d 1, certiorari denied, 434 U.S. 876, petition for rehearing pending. In *Lightcap* and *Kingery* v. *Continental Oil Co.*, 434 F. Supp. 349 (W.D. Tex.), the courts held that such provisions referred to the unregulated market. Cf. *J. M. Huber Corp.* v. *Denman*, 367 F.2d 104 (C.A. 5). The District of Columbia Circuit, however, expressed a contrary view in *Mobil Oil Corp.* v. *Federal Power Commission*, 463 F.2d 256, 265, certiorari denied, 406 U.S. 976. The courts of Louisiana have not yet ruled on the issue, although one case indicates the Supreme Court of Louisiana's view that the "market value" of gas sold for resale in interstate commerce can be established only by reference to the just and reasonable rate set by the Commission. *Whitehall Oil Co.* v. *Boagni*, 255 La. 67, 229 So.2d 702, 704-705. See also discussion, *infra*, pp. 35-37.

mitted by the Commission, and that they would ask the Commission for authority to "pass through" these increases to their interstate customer, United (A. 16, 18). Alternatively, Pennzoil and Shell would seek Commission authorization to abandon that portion of the gas sold under the leases which was attributable to Williams's royalty interest—that is, one-eighth and one-fourth of the gas produced under the 1934 and 1952 leases, respectively—so that that portion of the gas ("royalty gas") could be paid in kind to Williams for sale on the intrastate market. The authority to be sought under the Agreement would apply to sales of gas after the effective date of a Commission order granting the authority (A. 21, ¶ II-A).[5]

Pursuant to the agreement, Pennzoil and Shell moved the state court to stay their litigation pending disposition of the contemplated proceedings before the Commission (A. 23), and the state court granted the motion. When and if the Commission granted either form of relief, the parties would move to dismiss the state court action (*ibid.*). If the Commission denied both forms of relief, the parties would resume their state court litigation.

[5] In addition, ¶ II-B of the agreement (A. 21) provided that the producers would pay Williams additional royalties on volumes of gas delivered in 1974 (see A. 163-164). Shell and Pennzoil later sought Commission approval to pass through to United such retroactive payments as well (A. 163-164, 188-191). The Commission denied all the prospective relief requested and also authority to pass through the retroactive payments. See the discussion at pp. 8-10, *infra*.

As the agreement provided, Pennzoil and Shell filed petitions with the Commission seeking special relief from the area and national rates established by the Commisison to permit them to pass through to United the higher royalty rates called for in the settlement. Alternatively, they requested permission to abandon to Williams the portion of the gas produced under the leases that was attributable to Williams's royalty interests (A. 2-14).[6]

The Commission's administrative law judge, after a hearing, denied the petitions (A. 159-193). He concluded that under decisions of the Commission and the courts, exceptional relief from an area or nationwide rate established by the Commission is warranted only when a producer can demonstrate "that his overall costs incurred in the operation of the particular well or group of wells are higher than the applicable Commission-established area or nationwide ceiling rates, or, even more stringently, that his out-of-pocket expenses will exceed revenues" (A. 171). He found that Pennzoil had made no attempt to make such a showing (A. 175). He found that while Shell had made the attempt, the facts showed that at juris-

[6] United intervened in the Commission's proceeding and supported the petition by Pennzoil and Shell. United contended that the settlement was reasonable in view of the risk that the state court litigation might result in termination of the leases and thus diversion of the entire supply of gas from the interstate market (A. 52-53). United had agreed with Shell and Pennzoil to pay the higher prices called for by the settlement, "it being understood that the increases would be reflected in United's jurisdictional rates"—that is, passed on to its customers (United Br. in Opp. 3).

dictional rates Shell would still make an annual profit of more than $290,000 from its leases if it paid Williams royalties based on the 78-cent settlement figure, or an annual profit of more than $168,000 if it lost the state court litigation and paid Williams royalties based on the asserted current intrastate market price of $1.40 per Mcf (A. 178-180). The administrative law judge also denied the alternative request for the abandonment of the royalty gas, on the ground that the standards for abandonment under Section 7(b) of the Act, 15 U.S.C. 717f(b), had not been met (A. 185-188).

The Commission affirmed the decision of the administrative law judge, but on somewhat different grounds (A. 254-263; Pet. App. 14a-26a). With respect to the requested rate increase, the Commission observed that it did not have jurisdiction over the royalty owners or the royalty payments made to them by the producers,[7] and that a producer could "unilaterally" compute and pay royalties on any basis the producer chose (A. 260). The Commission held that it did have jurisdiction over the rates charged by the producer to an interstate pipeline, but that it would be inconsistent with its statutory mandate to permit the pass-through of costs based on the unregulated market price of gas (*ibid.*). The Commission stated (A. 261):

> In the instant proceeding, the impetus of the settlement is the market value of the royalties

[7] Citing *Mobil Oil Corp.* v. *Federal Power Commission*, 463 F.2d 256 (C.A. D.C.), certiorari denied, 406 U.S. 976 (A. 260).

> and no consideration has been given to regulated rates. As such, we cannot permit any incremental royalty costs resulting from this settlement, or resulting from any judgment by a state court regarding royalty payments, to be passed on to the pipeline if these incremental royalty costs are based on any other factors than the regulated just and reasonable rate. On this point, we note the Supreme Court's warning in *FPC* v. *Texaco* [417 U.S. 380] that the Commission is not free to equate just and reasonable rates with the prices for gas in the marketplace. Accordingly, we believe that we are not free to allow royalty costs, which are based on market values, to be passed on to the pipelines as just and reasonable rates. A contrary result would not "... afford consumers a complete, permanent, and effective bond of protection from excessive rates and charges" [quoting from *Atlantic Refining Company* v. *Public Service Commission*, 360 U.S. 378, 388].

Having concluded that to grant the price increase based on the unregulated rate would be at odds with the purpose of the Act, the Commission did not address the administrative law judge's determinations that Shell and Pennzoil had not demonstrated sufficient economic hardship to warrant relief from an area rate under the traditional Commission standards.

The Commission also concluded that abandonment of the royalty gas to Williams should not be authorized under Section 7(b) (A. 261-263). The Commission found that the supply of natural gas in the leaseholds was not so depleted as to warrant cessation of service, and that the public convenience and necessity

would not be served by granting an abandonment authorization that would "likely result in the subject gas being diverted from the interstate market to the intrastate market" (A. 262). The Commission rejected the argument of Pennzoil and Shell that abandonment of royalty gas would be in the public interest because otherwise Williams would cancel the leases, which would result in losing all of the gas to the intrastate market instead of only the royalty gas. The Commission held that Williams could not unilaterally terminate deliveries to United if it terminated the leases (A. 262). Relying on its decision in *El Paso Natural Gas Co.*, 54 F.P.C. 145, affirmed *sub nom. California* v. *Southland Royalty Co.*, No. 76-1587, decided May 31, 1978, the Commission stated (A. 262):

> If the lease were cancelled and Williams were to undertake to sell the subject gas, Williams would simply assume the obligations of Pennzoil and Shell to continue service to United.

The Commission subsequently denied petitions for rehearing (A. 290-295; Pet. App. 27a-33a). It reaffirmed the reasoning of its initial opinion and rejected contentions that this Court's decision in *Mobil Oil Corp.* v. *Federal Power Commission*, 417 U.S 283, established the authority of the Commission to allow royalty costs based on market value to be passed on to pipelines. The Commission stated that "[w]hile indicating that relief on some grounds may be possible, [*Mobil*] does not state under what conditions relief should be granted, nor does it define when the right to gain relief matures" (A. 291).

The court of appeals reversed the Commission's orders (Pet. App. 1a-9a). The court viewed the *Texaco* case (417 U.S. 380), on which the Commission had relied, as inapplicable (Pet. App. 6a). The court held that, since Commission rate regulation is cost-based, and "[o]ne of the components of a producer's costs is clearly its royalty expense" (*ibid.*), the Commission had erred in determining that it was not permitted to pass through to interstate customers the cost to lessee/producers of royalty payments based on intrastate market value. The court relied on this Court's decision in *Mobil Oil Corp.* v. *Federal Power Commission*, *supra*, for the proposition that producers are entitled to special relief from the Commission if their royalty costs, reasonably incurred, are higher than those provided for by the applicable area or national rate established by the Commission (*id.* at 7a-8a). The court observed that "[i]n all probability, the reasonableness of a great many costs of gas production must be determined by the prevailing market price in an uncontrolled market," and said the Commission had failed to explain "why royalty costs in an uncontrolled market are any different from any other cost" (*id.* at 7a).

On the issue of alternative relief, the court directed the Commission to reconsider its decision not to permit abandonment of the royalty portion of the gas. Relying on its decision in *Southland Royalty Co.* v. *Federal Power Commission*, 543 F.2d 1134 (C.A. 5), subsequently reversed in *California* v. *Southland Royalty Co.*, No. 76-1114, decided May 31, 1978,

the court held that the Commission had been wrong in thinking that the gas from the leaseholds "was trapped in the interstate market, whether or not the leases were terminated" (Pet. App. 9a).[8]

SUMMARY OF ARGUMENT

I

A. Basic principles of rate regulation under the Natural Gas Act prohibit the Commission from authorizing a rate increase above the applicable area or national rate to accommodate a producer's royalty cost that is tied to the unregulated intrastate market in natural gas. The Commission's responsibility under Section 4(a) of the Act is to set "just and reasonable" rates for interstate sales of natural gas. Several relevant principles, approved by this Court, govern the Commission's exercise of that responsibility. First, the Commission is not required to set rates with reference to each producer's particular costs, but may set rates on an area-wide or nationwide basis. Second, the Commission is not required to consider costs that are unreasonable. Third, the

[8] On the Commission's limited petition for rehearing, the court deleted from its opinion the final statement:

> It may well be that the "present or future public convenience or necessity" will suggest the propriety of abandoning a fraction of the gas in Williams' property, rather than lose the entire amount from the interstate market. This decision is for the Commission.

The court explained: "We agree with the Commission that the statement was premature, if construed to be decisional, and unnecessary with respect to our decision" (Pet. App. 13a).

Commission should not set rates on the basis of costs that arise from contract clauses providing for indefinite price escalations or that are otherwise unrelated to the circumstances or the economics of the particular operation. Fourth, as this Court held in *Federal Power Commission* v. *Texaco*, 417 U.S. 380, the Commission may not establish rates on the basis of the unregulated market price of natural gas. The foregoing principles, particularly those set forth in *Texaco*, establish that the Commission has no authority to permit rate increases based on royalty costs tied to the unregulated market for natural gas.

B. The court of appeals, in holding that the Commission had the authority to pass through such royalty costs, did not expressly hold that the Commission was required to do so. But the rationale and the necessary implications of the court's holding would effectively compel that result in many cases. The court's decision would thus significantly impair the Commission's ability to establish just and reasonable rates.

The court's decision was based on its view that producers are entitled to individualized rate relief when, as the court thought to be true of Shell and Pennzoil, they are placed by their royalty obligations in a financial bind that reduces the funds otherwise available to them for exploration and development. The decision seems thus to establish a presumption that such relief must be granted unless exceptional circumstances are present. At best, the decision would require the Commission to review the circumstances

of each case to determine, for example, the reasonableness of the producer's having incurred particular royalty costs tied to the unregulated market. The Commission would be prohibited from excluding such costs generically on the ground that their inclusion would be inconsistent with the basic purpose of the Act.

C. The arguments advanced by respondents and the court of appeals do not support the court's decision.

1. Contrary to respondents' assertion, the royalty costs in this case are based on the unregulated market. Although those costs are presently embodied in a settlement agreement, the settlement reflects the claim being settled—a claim for royalties based on the unregulated market. As the Commission held, the only reason Shell and Pennzoil agreed to pay royalties higher than they had been paying was the claim made against them in state court for royalties based on the unregulated market.

2. As *Texaco* indicates, it is immaterial that royalty costs are only one component of the producers' costs, or that they do not equal the unregulated price of gas, but are only a percentage of that price. Whatever the size of the cost component, the Act does not permit this method of calculating just and reasonable rates.

3. Contrary to the court of appeals' view, royalty costs based on the price of natural gas in the unregulated market are not the same as other costs of production that may properly be determined by reference to unregulated markets. The critical difference

is that the royalty costs at issue here are tied to the unregulated price for the very commodity whose price the Commission is charged with regulating.

4. The court of appeals also erred in concluding that *Mobil Oil Corp.* v. *Federal Power Commission*, 417 U.S. 283, holds or suggests that the Commission has authority to grant the rate increases requested by Shell and Pennzoil here. In *Mobil*, this Court viewed as hypothetical, and therefore declined to rule on, a producer's claim that the Commission, in an area rate proceeding, had failed to provide for future increases in royalty costs. In stating that producers oppressed by individual costs might seek individualized relief, the Court indicated nothing about the circumstances in which such relief might be appropriate.

In fact, it is well-established that the Commission will not authorize special relief from an area rate unless a producer can show that its costs exceed its revenues at that rate—a showing neither Shell nor Pennzoil could make in this case. The court of appeals therefore erred in concluding that, because Shell and Pennzoil may face increased royalty costs from state court judgments that would "absorb funds otherwise available for exploration and development" (Pet. App. 8a), the Commission was required to consider their requests for special relief.

II

The Commission properly denied the alternative request of Shell and Pennzoil to allow abandonment of "royalty gas" from the leaseholds so that it could

be paid "in kind" to the lessor for sale on the intrastate market. The contrary determination of the court of appeals was based on its decision in *Southland Royalty Co.* v. *Federal Power Commission*, 543 F.2d 1134, which this Court later reversed in *California* v. *Southland Royalty Co.*, No. 76-1114, decided May 31, 1978. This Court's decision establishes that the Commission was correct and the court of appeals in error.

ARGUMENT

I. UNDER THE NATURAL GAS ACT THE COMMISSION MAY NOT AUTHORIZE PRODUCERS TO PASS THROUGH TO INTERSTATE CONSUMERS ROYALTY COSTS BASED ON THE UNREGULATED INTRASTATE PRICE OF NATURAL GAS

The court of appeals held that the Commission has authority under the Natural Gas Act to permit producers to pass through to pipelines, and hence to interstate consumers, royalty costs based on the unregulated price of natural gas in the intrastate market. We will show that (A) the decision is contrary to basic principles of rate regulation established by the Act and by decisions of this Court; (B) although the court did not expressly hold that the Commission was required to permit the pass-through of such royalty costs, its holding that the Commission has the authority to do so, and the rationale for that holding, would significantly impair the Commission's ability to fulfill its statutory mandate of ensuring just and reasonable rates; and (C) the reasons offered by the

court and respondents in support of the decision are unpersuasive.[9]

A. Basic Principles of Rate Regulation Establish That The Commission Has No Authority to Permit Producers to Pass Through Royalty Costs Based On The Unregulated Market Price of Natural Gas

Section 4(a) of the Natural Gas Act, 15 U.S.C. 717c(a), requires the Commission to ensure that all rates charged for the transportation or sale of natural gas subject to the Commission's jurisdiction are "just and reasonable." As a general matter, the Commission, like most rate-regulating bodies, establishes rates on the basis of the seller's costs plus a reasonable rate of return. See *Permian Basin Area Rate Cases*, 390 U.S. 747, 756-762. Several other well-settled principles, however, also govern the Commission's rate-setting responsibilities under the Act.

First, the Commission has authority to establish the maximum rates producers may charge on an area-wide or nation-wide basis, and is not required to promulgate an individual rate for each producer on the basis of his own particular costs. *Permian Basin Area Rate Cases, supra; Mobil Oil Corp.* v. *Federal Power Commission*, 417 U.S. 283. In recent years, the Commission has in fact promulgated rates on an

[9] Congress is presently considering a bill entitled The Natural Gas Policy Act of 1978, H.R. 5289, 95th Cong., 2d Sess. (1978). On August 18, 1978, a conference committee report was issued on the bill reflecting agreement on the part of the managers of the House and Senate. S. Rep. No. 95-1126, 95th Cong., 2d Sess. To the extent that future legislature appears to affect the issues in this case, we will advise the Court in a supplemental memorandum.

area-wide or nation-wide basis.[10] While the Commission may grant special rate adjustments or other relief to a producer in exceptional circumstances, it is not required to do so merely because the producer's own costs exceed the area or national average. *Permian, supra*, 390 U.S. at 770-772. As this Court said in *Federal Power Commission* v. *Texaco*, 417 U.S. 380, 387: "That every rate of every natural gas company must be just and reasonable does not require that the cost of each company be ascertained and its rates fixed with respect to its own costs."

Second, the fact that one or even all producers incur a particular cost does not require the Commission to include all of that cost in the rate base if it is excessive or unreasonable. If, for example, a producer or group of producers were paying a price for drilling material that was twice the price reasonably available from other suppliers, or were using platinum instead of steel pipe, the Commission would not be required to pass those costs on to interstate pipelines, and hence to interstate consumers, as part of the jurisdictional rate. See *Permian, supra*, 390 U.S. at 824-825, n. 115; *Mobil Oil Corp.* v. *Federal Power Commission*, 463 F.2d 256, 263 (C.A. D.C.), certiorari denied, 406 U.S. 976. Rather the Commission's responsibilities under the Act are "so framed as to afford *consumers* a complete, permanent and

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[10] See, *e.g.*, *Permian, supra* (upholding area rates); *Shell Oil Co.* v. *Federal Power Commission*, 520 F.2d 1061 (C.A. 5), certiorari denied, 426 U.S. 941 (upholding national rates).

effective bond of protection from excessive rates and charges." *Atlantic Refining Co.* v. *Public Service Commission*, 360 U.S. 378, 388 (emphasis supplied).

Third, in accord with its responsibility to ensure that rates are reasonable, the Commission may refuse to establish rates that reflect contract clauses providing for indefinite price escalations. In *Permian* this Court affirmed the Commission's refusal to permit rate increases based on such clauses, citing the Commission's statement that to allow the increases would not be "in accordance with the principles upon which a rate structure should be based" and would be "incompatible with the public interest." 390 U.S. at 782-783 (quoting from the Commission's orders in 34 F.P.C. 159, 236 and 25 F.P.C. 379, 380). That is so because the escalation clauses "cause price increases * * * to occur without reference to the circumstances or economics of the particular operation, but solely because of what happens under another contract." 34 F.P.C. at 373; 390 U.S. at 782-783. See also *Federal Power Commission* v. *Texaco, Inc.*, 377 U.S. 33, 42.

Fourth, the Commission is not permitted by the Act to establish regulated rates on the basis of the unregulated market price of natural gas. To do so is inconsistent with the very notion of rate regulation, and this Court expressly so held in *Federal Power Commission* v. *Texaco*, 417 U.S. 380. In that case the Commission sought by rule to exempt small jurisdictional producers from most of the regulatory requirements of the Act, including individual certification, filing of rate increases, and refund obligations. The

Commission sought to regulate the rates of the small producers only indirectly, through its regulation of large producers and pipelines who purchased gas from the small producers and whose costs therefore reflected the prices paid to the small producers.

The Court rejected the Commission's rule. The Court noted that the rule appeared to permit the large producers and pipelines to pass through automatically the unregulated prices they paid to the small producers, and that "the implication appears to be that reasonableness would be judged by the standard of the marketplace" (417 U.S. at 396). The Court stated (*id.* at 397-399):

> [W]e should also stress that in our view the prevailing price in the marketplace cannot be the final measure of "just and reasonable" rates mandated by the Act. It is abundantly clear from the history of the Act and from the events that prompted its adoption that Congress considered that the natural gas industry was heavily concentrated and that monopolistic forces were distorting the market price for natural gas. * * * In subjecting producers to regulation because of anti-competive conditions in the industry, Congress could not have assumed that "just and reasonable" rates could conclusively be determined by reference to market price. Our holding in *Phillips* [347 U.S. 672] implies just the opposite. * * * [Footnote omitted].

See also *Federal Power Commission* v. *Sunray DX Oil Co.*, 391 U.S. 9, 25-26, where the Court specifically rejected the contention that prevailing market prices —in the form of contemporaneous contract prices—

could be equated with "just and reasonable" rates under the Act.

The court of appeals' decision is contrary to the foregoing principles, and particularly to those set forth in *Texaco*. Shell and Pennzoil have requested the Commission to approve an increase in their jurisdictional rates that would be based on the price of gas in the unregulated market. That increase, and hence a significant part of the entire rate, would "conclusively be determined by reference to market price" (*Texaco, supra,* 417 U.S. at 399).[11]

Furthermore, if the Commission permitted a rate increase based on the unregulated market price, jurisdictional rates would be subject to unpredictable fluctuations and escalations that are beyond the control of the Commission, are unrelated to "the circumstances or economics of the particular operation," and are solely a function of "what happens under [o]ther contract[s]." *Permian, supra,* 390 U.S. at 782-783. In this case, for example, Williams claimed that Pennzoil and Shell owed royalties on the basis of market prices ranging from $.35 per Mcf in 1971 (A. 115) to $1.40 per Mcf in 1975 (A. 119-121). Market prices will no doubt continue to fluctuate, and probably to escalate if present trends continue. No less than in *Permian*, to permit increases in juris-

[11] This is so notwithstanding the settlement and the use of the royalty figures set forth in that settlement; the settlement reflected the claim being settled, and that claim was for "market value" royalties determined by the intrastate market. See pp. 26-27, *infra*.

dictional rates on the basis of such unpredictable market fluctuations would be inconsistent " 'with the principles upon which a rate structure should be based.' " 390 U.S. at 782.[12]

B. The Court of Appeals' Decision Would Significantly Impair the Commission's Ability to Ensure Just and Reasonable Rates

As we have shown, the court of appeals disregarded basic regulatory principles in holding that the Commission has authority to permit producers to pass through royalty costs based on the price of gas in the unregulated market.[13] The court, however, did

[12] Moreover, from the standpoint of the interstate consumers for whose protection the Act was passed (*Atlantic Refining Co.* v. *Public Service Commission, supra*), the circumstances of this case provide no reason for permitting Shell and Pennzoil to increase their rates in response to their lessor's demands for higher royalty rates. As discussed *infra*, pp. 37-41 and note 24, this Court's decision in *California* v. *Southland Royalty Co.*, No. 76-1114, decided May 31, 1978, establishes that the lessor, if he terminated the leases, would be required to continue the interstate service at applicable Commission rates. Thus there is no reason to impose a higher rate on interstate consumers merely because of the private contractual arrangements between the parties in this case.

[13] While the basic scheme of the Act prohibits the Commission from allowing the pass-through of such costs, the prohibition has practical significance only when, as in this case, a producer seeks Commission authorization for a rate higher than the applicable area or national rate. The Commission's area and national rates are ceilings; nothing bars a producer from charging a lower rate. If the Commission establishes a just and reasonable ceiling rate on the basis of factors unrelated to the price of gas in the intrastate market, and a particular producer has a royalty cost that is based on the intrastate market price, there is nothing that prevents that producer from paying that cost and reflecting it in his rate, so long as the rate he charges does not exceed the Commission's ceiling. What the Act prohibits is the Commission's establishment of ceiling rates based on the price of natural gas in the intrastate market, or, as is proposed in this case, the Commission's authorizing a particular producer to charge a rate in excess of the applicable ceiling because of costs pegged to the price of gas in the intrastate market.

not expressly *require* the Commission to permit the pass-through of such costs. It might be suggested, then, that the Commission can still refuse to grant such permission, in which case the court's decision, however erroneous, might not be particularly significant. The necessary implications of the court's decision, however, would compel the Commission to permit such pass-throughs in many, if not most cases, and thus to increase rates on the basis of an illegal factor. The decision would thus seriously impair the Commission's ability to ensure just and reasonable rates.

The court's decision would in practice affect the level of just and reasonable rates in several ways. First, the Commission, as we have noted (pp. 17-18, *supra*), is not required to calculate its rates with reference to each producer's particular costs, but may use area or national averages. In individual cases, the Commission might be justified in declining to permit the pass-through of "market value" royalty costs even if it had the authority to grant such permission. But if many producers incur a significant cost that the courts hold to be properly includable in the rate base, as the court of appeals has effectively held here, that

cost will affect the average. The number of "market value" royalty provisions in gas leases, together with the substantial cost impact of such provisions if they are held to refer to the intrastate market, may well produce such an effect.[14]

More important, even if the costs in question here were incurred by only a few producers, it is doubtful that, under the court's rationale, the Commission would be justified in denying individualized rate relief to those producers. For the court's conclusion was based, at least in part, on its view that Shell and Pennzoil would be " 'put in a bind by their royalty obligations' " if they lost the state court litigation, and on the court's apparent view that this Court's decision in *Mobil Oil Corp.* v. *Federal Power Commission*, 417 U.S. 283, requires the Commission to provide individualized relief to producers in such circumstances (Pet. App. 8a). At the least, therefore, the decision appears to establish a heavy presumption that individual relief must be granted to such producers, and would preclude the Commission from denying relief on the basis of its view that rate increases based on the price of gas in the unregulated market are inconsistent with the purpose of the Act.

[14] As noted earlier (p. 5, note 4, *supra*), the Commission does not have information concerning the number of leases containing "market value" royalty provisions or the amounts of gas underlying such leases, but the volume of pending litigation over such provisions suggests that their impact (if interpreted to refer to the intrastate market) would be significant.

In some cases the Commission might conclude that a given producer had been unreasonable in incurring royalty costs based on the intrastate market price. Under the court's rationale, however, the Commission plainly could not conclude that incurring such costs was unreasonable *per se*. And if the court is correct that under the scheme of the Act such costs may properly be included in the rate base for Commission-established rates, it is difficult to see what circumstances would justify a conclusion that incurring the costs was unreasonable.

In short, the court of appeals' decision, at best, would require the Commission to review the circumstances of each case to determine whether particular royalty costs based on the intrastate market for natural gas were or were not permissible for individualized reasons. The decision would prohibit the Commission from excluding such costs generically on the ground that their inclusion would undermine the purpose of the Act. The likely consequence of the decision would be to establish a strong presumption that such costs must be included, and that petitions such as that of Shell and Pennzoil must be granted by the Commission in the absence of exceptional circumstances.

C. The Arguments Advanced by Respondents And The Court of Appeals Do Not Support The Court's Decision

1. *The Increased Royalty Costs That Shell and Pennzoil Seek to Pass Through Are Based on The Unregulated Market Price*

Respondents Pennzoil and Shell have argued that the increased royalty costs they seek to pass through to interstate consumers are not based on the intrastate market price but on prices agreed to by Shell, Pennzoil, and Williams as part of their settlement.[15] The argument ignores the realities of the situation and was properly rejected by the Commission.[16]

The cause of the settlement was the claim being settled: the claim by Williams that Shell and Pennzoil owed it royalties based on the intrastate market price. Shell and Pennzoil have never suggested any other reason for agreeing to pay royalties substantially higher than they had been paying for years. Thus the Commission correctly observed (A. 261) that "the impetus of the settlement is the market value of the royalties and no consideration has been given to regulated rates."

If we are correct that passing through royalty costs based on the intrastate market price of gas offends the basic scheme of the Act, private litigants cannot make such a result acceptable by agreeing on royalty costs that are somewhat less than the royalty owner's original "market value" claim.[17]

[15] Pennzoil Br. in Opp. 9; Shell Br. in Opp. 3, n. 3.

[16] The court of appeals did not address this argument but implicitly rejected it, since its opinion addressed the merits of the Commission's position that it had no authority to pass through royalty costs based on the intrastate market price.

2. *The Fact that "Market Value" Royalty Costs Are Only Part of the Producers' Total Costs Does Not Provide a Basis for Distinguishing This Court's Decision in* Federal Power Commission *v.* Texaco, Inc., *417 U.S. 380*

The court of appeals stated that this Court's decision in *Texaco, supra,* was "inapplicable to the instant case" (Pet. App. 6a). The court gave little indication of its reasons.[18] But they appear to be based on the view, amplified in the arguments of respondents,[19] that the jurisdictional rate considered in *Texaco* was determined solely by reference to the unregulated market price, whereas in this case only one component of the producers' cost would be determined by reference to the unregulated market price.

The claim is factually incorrect. The cost at issue in *Texaco* was the price the regulated producers paid

[17] See *Texaco, supra,* 417 U.S. at 399.

[18] The court said that "[t]his case deals with royalty cost under specific leases" (*ibid.*). But that scarcely distinguishes *Texaco,* where, as the court recognized, this Court "held that the final measure of 'just and reasonable' rates, mandated by sections 4 and 5 of the Act, could not be the prevailing price in the unregulated marketplace" (*ibid.*). Nothing in the Act suggests—and the court did not claim—that rates for the interstate sale of gas "under specific leases" need not be "just and reasonable."

[19] Pennzoil Br. in Opp. 10; Shell Br. in Opp. 2-3.

for gas purchased from the small producers. Like the cost at issue here, it was only one component of the total costs of the regulated producers. Under the Commission's plan in *Texaco*, that component would have been included with all the other costs of the regulated producers to determine their jurisdictional cost base.

More important, as *Texaco* itself indicates, the fact that royalty costs are only one of several components of the producers' costs is immaterial. They are a significant component, and the principles reaffirmed in *Texaco* do not suggest that a part of the interstate rate approved by the Commission may be based solely on the unregulated market so long as the whole rate is not determined on that basis. As this Court stated, "the Act makes unlawful all rates which are not just and reasonable, and does not say a little unlawfulness is permitted" (417 U.S. at 399).

Nor does the particular ratio between the royalty cost and the unregulated price make a legal difference. The ratios here are substantial—one-eighth and one-fourth—but in any event the court of appeals' rationale would apply if the leases provided for royalties equalling 90 percent of the "market value," thus resulting in jurisdictional rates approaching parity with the unregulated market. Whether the cost component that is determined by reference to the unregulated market is large or small, the Act does not permit the Commissioner to calculate just and reasonable rates by that method.

3. *The Fact That "Market Value" Royalties Are Costs Actually Paid by the Producers Does Not Authorize or Require the Commission to Permit Them To Be Passed Through to Interstate Consumers*

The court of appeals stated, and respondents have argued,[20] that royalty costs are no different from any other cost of production and therefore, under "a cost plus profit approach to gas rate regulation" (Pet. App. 6a), should be included in the rate base if they are reasonable. As the court stated (Pet. App. 7a):

> Determination of the reasonableness of a cost necessarily requires consideration of market price. In all probability, the reasonableness of a great many costs of gas production must be determined by the prevailing market price in an uncontrolled market. The Commission has failed to suggest why royalty costs in an uncontrolled market are any different from any other cost.

The difference is plain. The royalty costs at issue here are pegged to the unregulated market price of the very commodity whose interstate price the Commission is charged with regulating. In contrast to the costs of labor, steel, or other elements of production whose price the Commission has no responsibility for regulating, royalty costs based on the unregulated price of natural gas would undermine the premise of price regulation of natural gas. To allow the pass-through of such costs would be to ignore the Act's objective of "afford[ing] consumers a complete,

[20] Pennzoil Br. in Opp. 9-10; Shell Br. in Opp. 2-3.

permanent and effective bond of protection from excessive rates and charges" (*Atlantic Refining Co.* v. *Public Service Commission*, *supra*, 360 U.S. at 388), by spiriting into the just and reasonable rates mandated by the Act the very unregulated rates and charges against which protection was sought. See also, *e.g.*, *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672, 682-684.[21]

4. *This Court's Decision in* Mobil Oil Corp. *v.* Federal Power Commission, *417 U.S. 283, Does Not Support the Decision of the Court of Appeals*

The court of appeals relied on this Court's decision in *Mobil Oil Corp.* v. *Federal Power Commission*, 417 U.S. 283, affirming *Placid Oil Co.* v. *Federal Power Commission*, 483 F.2d 880 (C.A. 5), for its conclusion that the Commission has authority, if not an obligation, to permit the pass-through of "market value" royalty costs. The court of appeals reasoned that because the state courts may ultimately determine that the "market price" clauses of the Williams leases refer to the intrastate market, Shell and Pennzoil have been "put in a bind" between the jurisdictional rate and their royalty obligations—a situation in which they face either termination of their leases or "increased royalty payments, which would absorb funds otherwise available for exploration and development" (Pet. App. 8a). The court concluded that *Mobil* requires the Commission at least to consider, and apparently to grant, individualized relief to producers placed in such a bind (*ibid*; see p. 24, *supra*).

[21] Moreover, contrary to the court of appeals' suggestion, the Commission would not necessarily be required to include in the rate base other costs of production that were tied by agreement to fluctuations in an unregulated market. Prevailing market prices for, say, steel or labor may be taken into consideration when the Commission establishes jurisdictional rates. But if a producer entered into a long-term labor or materials contract that fixed his price of labor or materials on some imprudent basis and not as a function of local conditions or the circumstances of the particular operation, it would be open to the Commission to determine that the future pass-through of such costs is unreasonable and not " 'in accordance with the principles upon which a rate structure should be based.' " *Permian*, *supra*, 390 U.S. at 782.

Mobil imposes no such requirement. Nor does the alleged bind in which Shell and Pennzoil have been placed, or will be placed, warrant any departure from the basic principles of rate regulation under the Act.

a. In *Mobil* the court of appeals and this Court upheld an area rate promulgated by the Commission. One of the many objections considered by the Commission and the courts was Mobil's complaint that the Commission had failed to provide for automatic rate adjustments to accommodate anticipated increased royalty costs. The Commission found the issue to be premature in the context of the area rate proceeding. The court of appeals agreed, stating (483 F.2d at 911; emphasis in original):

> [W]e are not willing to alter or stay the implementation of area wide rates for the entire industry merely on the basis of what *might* happen to *some* producers' costs *if* this statement of the law prevails.
>
> If, as subsequent events develop, the producers are put in a bind by their royalty obligations,

> they may certainly petition FPC for individualized relief. * * * [W]e find it to be far preferable to speculative prophesies of future royalty components. If the royalty obligations are such as to make the rates established by [the Commission's decision] and approved by us here, confiscatory or otherwise inappropriate, those producers who are materially affected will certainly have recourse to the administrative process. * * *

This Court "agree[d] with the Court of Appeals that Mobil's argument is hypothetical at this stage and that in any event an affected producer is entitled to seek individualized relief" (417 U.S. at 328). In making that observation the Court recognized that the Commission may grant special relief in some instances where actual costs are higher than those provided for in the area rate. It did not discuss or determine what those instances might be, or what kinds of royalty obligations might make the established rates, in the words of the court of appeals, "confiscatory or otherwise inappropriate." In particular, the Court did not consider whether the Commission either could or must grant relief for royalty obligations tied to the unregulated price of gas in the intrastate market.

b. When that question is considered, the "bind" that Shell, Pennzoil, and other producers may face would warrant no such relief. That bind would result from two rulings. On the one hand, the Court of Appeals for the District of Columbia held in *Mobil Oil Corp.* v. *Federal Power Commission*, 463

F.2d 256, certiorari denied, 406 U.S. 976, that lessors (or "royalty owners") are not natural-gas companies under the Act and hence that the Commission lacks jurisdiction over the terms of lease agreements, including royalty provisions. On the other hand, some state courts have held, and others may, that "market value" or "market price" royalty clauses refer to the unregulated intrastate market. See, p. 5, note 4 *supra*.

Even if both rulings are correct (but see the discussion at pp. 35-37, *infra*), they do not warrant the relief requested by respondents. If we assume that a lessor may charge a lessee/producer any royalty the latter is willing to pay, it does not follow that the Commission is authorized or required to pass all of that royalty on to interstate customers. In *Permian* this Court established that neither the Constitution nor the Natural Gas Act is offended by a rate structure that denies full recovery of all costs to some producers. "No constitutional objection arises from the imposition of maximum prices merely because 'high cost operators may be more seriously affected * * * than others,' *Bowles* v. *Willingham* [321 U.S. 503, 518], or because the value of regulated property is reduced as a consequence of regulation" (390 U.S. at 769). The Court upheld in that case the Commission's policy that, while it might grant relief from the area rate in some circumstances, "a producer's inability to recover either its unsuccessful exploration costs or the full 12% return on its production investment would not, without more, warrant relief,"

and that "the burden would be upon the producer to establish the propriety of an exception * * *" (390 U.S. at 771).

In accordance with those principles, the Commission, with the approval of the courts, has established the policy that it will not authorize departures from area rates unless a producer can show that its costs exceed its revenues at the area rate. See, *e.g.*, Opinion No. 699, 51 F.P.C. 2212, 2279, affirmed, *Shell Oil Co.* v. *Federal Power Commission*, 520 F.2d 1061 (C.A. 5), certiorari denied, 426 U.S. 941. In the present case the administrative law judge denied relief on the ground that Shell and Pennzoil had made no such showing, and that Shell at least would still derive a substantial profit from its lease even if it paid the higher royalties (see pp. 7-8, *supra*).

The Commission, without rejecting these findings, denied relief on grounds more fundamental to the scheme of the Act, and we are not suggesting that the Commission be affirmed on grounds that it did not itself rely on. We do contend, however, that the court of appeals erred in holding that the Commission was authorized, if not required, to grant relief because the producers faced a financial bind resulting from "increased royalty payments, which would absorb funds otherwise available for exploration and development" (Pet. App. 8a). Even if a particular producer's costs would "absorb funds otherwise available" for those uses, that in itself is not a ground for relief from an area rate.

c. In any event, the "bind" asserted by Shell and Pennzoil, and relied on by the court of appeals, cannot at this point be assumed to exist. The state courts of Louisiana have not determined whether the leases require royalties based on intrastate market prices or on the regulated prices at which the gas is actually sold. As noted earlier (p. 5, note 4, *supra*), that issue has been addressed in only a few reported cases, and those courts are divided. In this case the administrative law judge, noting that "the dire results envisaged by Pennzoil and Shell from the state court litigation are, of course, speculative," expressed the view that "[i]t is highly doubtful that Williams would prevail on its claim that 'market value' for basing royalty payments means a price in excess of the Commission-established area and nationwide ceiling prices" (A. 182).

While we express no view on the likely outcome of the state court litigation, we do believe that the administrative law judge was correct in concluding that "market value" royalty clauses, properly construed, refer to the market in which the parties contemplated that the gas would be sold—in this case, the regulated interstate market. See A.182-183; see also *Mobil Oil Corp.* v. *Federal Power Commission*, 463 F.2d 256, 265 (C.A. D.C.), certiorari denied, 406 U.S. 976.

We also believe that when such clauses apply to sales within the jurisdiction of the Commission, the question is one of federal law. When the Commission establishes jurisdictional rates, it properly takes

into account the funds needed by jurisdictional producers for exploration and development, as well as the fair rate of return. Although an individual producer has no entitlement to rate relief on the ground that his own costs deprive him of funds that the Commission anticipates will be available to the average producer, at the same time state courts cannot impair the Commission's ability to carry out its responsibilities under the Act. When state courts, on the basis of state law, impose on jurisdictional producers a cost that the Commission is precluded by the Act from including in jurisdictional rates, they undermine the purposes and impair the effectiveness of the federal statute. Cf. *Northern Natural Gas Co.* v. *State Corporation Commission of Kansas*, 372 U.S. 84, 91.

We have expressed these views in our memorandum supporting the petition for rehearing of the denial of certiorari in *Mobil Oil Corp.* v. *Lightcap*, No. 76-1694, where "market value" royalty clauses were held to refer to the unregulated market. The resolution of the present case does not turn on the resolution of the issue in *Lightcap*; even if the producer's royalty obligation is measured by the unregulated market, the Commission cannot pass through such increased costs to the interstate consumer. Nevertheless, the issues are plainly related. A judicial rejection of the view that "market value" royalty clauses refer to the intrastate market, where sales were contemplated and are actually being made in the interstate market, would obviate the "bind" that respond-

ents assert and would promote the regulatory purposes of the Act.[22]

II. THE COMMISSION PROPERLY DENIED THE REQUEST TO ALLOW ABANDONMENT OF ROYALTY VOLUMES OF GAS DEDICATED TO INTERSTATE COMMERCE

As an alternative to the requested price relief, Shell and Pennzoil petitioned the Commission to authorize abandonment, pursuant to Section 7(b) of the Act, 15 U.S.C. 717f(b), of portions of the leasehold gas attributable to Williams' royalty interest (that is, one-eighth and one-fourth of the gas produced under the 1934 and 1952 leases, respectively), so that Williams

[22] In our petition for a writ of certiorari in this case we suggested that another alternative would be reconsideration of the decision of the District of Columbia Circuit in *Mobil Oil Corp.* v. *Federal Power Commission*, 463 F.2d 256, certiorari denied, 406 U.S. 976, holding that the Commission has no jurisdiction over royalty payments under leases because lessors are not natural gas companies within the meaning of the Act. On further consideration, we do not press that suggestion here. For one thing, the Commission in its opinion accepted the D.C. Circuit's decision in *Mobil* and stated that lessors and lessee/producers could unilaterally charge and pay any royalty they desired, so long as it was not passed through to interstate customers (A. 260; Pet. App. 21a-22a). See *Burlington Truck Lines* v. *United States*, 371 U.S. 156, 168-169. But see *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672. Further, the purposes of the Act would not require a conclusion contrary to that of the court of appeals in *Mobil* if we are correct in our position that costs calculated on the basis of the unregulated market cannot be included in regulated rates, and in our position that federal law requires that "market value" royalty clauses affecting jurisdictional sales be construed as referring to the regulated rate.

could take this "royalty gas" in kind and dispose of it in the intrastate market (see pp. 6-7, *supra*). Section 7(b) provides:

> No natural-gas company shall abandon * * * [any facilities or any service subject to the jurisdiction of the Commission] without the permission and approval of the Commission first had and obtained, after due hearing, and a finding by the Commission that the available supply of natural gas is depleted to the extent that the continuance of service is unwarranted, or that the present or future public convenience or necessity permit such abandonment.

Shell and Pennzoil argued to the Commission that the public interest would be served by authorization to abandon the royalty gas, because otherwise the leases might be cancelled and all of the gas, not just the royalty portion, diverted from the interstate market.[23] The Commission found this fear unwarranted (A. 262):

> [W]e do not share the concern * * * that Williams could terminate deliveries to United even if the leases were cancelled as a result of state court litigation. If the lease were cancelled and Williams were to undertake to sell the subject gas, Williams would simply assume the obligations of Pennzoil and Shell to continue service to United.

[23] It was undisputed that the available supply of gas underlying the leased lands was not depleted, so that abandonment could not be permitted on that basis (see A. 186, n. 15).

The Commission concluded that diversion of the royalty gas from the interstate market would not serve the public convenience and necessity, and the abandonment request was accordingly denied (A. 263).

The court of appeals remanded the issue to the Commission for reconsideration in light of the court's then-recent decision in *Southland Royalty Co.* v. *Federal Power Commission*, 543 F.2d 1134 (C.A. 5), reversed *sub nom. California* v. *Southland Royalty Co.*, No. 76-1114, decided May 31, 1978. The court held that the Commission "was acting under the wrong legal premise" in denying abandonment—that is, "the Commission was under the impression that Williams' gas was trapped in the interstate market, whether or not the leases were terminated" (Pet. App. 9a).

This Court's decision in *Southland Royalty* establishes that the Commission was correct and the court of appeals in error. The Court held that the expiration of a lease does not affect the obligation to continue the interstate service from the leased acreage, unless the Commission authorized abandonment:

> This issuance of a certificate of unlimited duration covering the gas at issue here created a federal obligation to serve the interstate market until abandonment had been obtained. The Commission reasonably concluded that under the statute the obligation to continue service attached to the gas, not as a matter of contract but as a matter of law, and bound all those with dominion and

> power of sale over the gas, including the lessor to whom it reverted. [Slip op. 6.]

Southland Royalty involved a 50-year lease that terminated automatically by the passage of time. The Court's decision there applies at least as strongly to the situation posited here, which would be the unilateral termination of a lease by the lessor prior to its specified term. There is, indeed, even less basis for the claim that interstate service may be abandoned, without the Commission's approval, by a lessor who terminates a lease prematurely out of a desire to divert gas to the more lucrative intrastate market.

Thus, the Commission's reasoning that Williams would be obligated to continue the interstate service initiated by Pennzoil and Shell, even if the leases were cancelled, is squarely validated by *Southland Royalty* (slip op. 7):

> Once the gas commenced to flow into interstate commerce from the facilities used by the lessees, § 7(b) required that the Commission's permission be obtained prior to the discontinuance of "any service rendered by means of such facilities." Private contractual arrangements might shift control of the facilities and thereby determine *who* is obligated to provide that service, but the parties may not simply agree to terminate the service obligation without the Commission's permission.

Correspondingly, the court of appeals' basis for reversing the Commission's refusal here to allow abandonment of the royalty gas has been rejected. In the light of *Southland Royalty*, the court's holding on this

issue should be reversed, and the Commission's determination affirmed.[24]

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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[24] As noted *supra*, p. 22, note 12, this conclusion provides further support for the Commission's denial of the rate increases requested by Shell and Pennzoil. If Williams cancelled the leases and was required to continue the interstate service, as *Southland Royalty* held would be the case, Williams's sales in interstate commerce would be subject to the applicable Commission ceiling rates. It would be anomalous to permit Shell and Pennzoil to increase their rates above the ceiling because otherwise Williams might cancel their leases, when Williams itself could not charge a higher-than-ceiling rate if it did cancel.

APPENDIX

Section 4(a) of the Natural Gas Act, 52 Stat. 822, as amended, 15 U.S.C. 717c(a) provides:

> All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is declared to be unlawful.

Section 7(b) of the Natural Gas Act, 52 Stat. 824, 15 U.S.C. 717f(b) provides:

> No natural-gas company shall abandon all or any portion of its facilities subject to the jurisdiction of the Commission, or any service rendered by means of such facilities, without the permission and approval of the Commission first had and obtained, after due hearing, and a finding by the Commission that the available supply of natural gas is depleted to the extent that the continuance of service is unwarranted, or that the present or future public convenience or necessity permit such abandonment.

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